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The 1979 Benjamin F. Fairless Memorial Lectures

Harold M. Williams
& Irving S. Shapiro

Power and Accountability

The Changing Role of the Corporate Board of Directors

The Benjamin F. Fairless Memorial Lectures endowment fund has been established at Carnegie-Mellon University to support an annual series of lectures. Two internationally known figures from the world of business, government, or education are invited each year to lecture at Carnegie-Mellon under the auspices of its Graduate School of Industrial Administration. In general, the lectures are concerned with some aspects of business or public administration; the relationships between business and government, management and labor; or a subject related to the themes of preserving economic freedom, human liberty, and the strengthening of individual enterprise — all of which were matters of deep concern to Mr. Fairless throughout his career.

Benjamin Fairless was president of United States Steel Corporation for fifteen years, and chairman of the board from 1952 until his retirement in 1955. A friend of Carnegie-Mellon University for many years, he served on the board of trustees from 1952 until his death. In 1959 he was named honorary chairman of the board.

Mr. Fairless died January 1, 1962.

Harold M. Williams, of California, took the oath of office as chairman of the Securities and Exchange Commission on April 21, 1977. Since July 1, 1970, Mr. Williams had been dean and professor of Management of the UCLA Graduate School of Management. During his administration, the school achieved national ranking, including recognition as the leading graduate business school in a public university.

Mr. Williams received his B.A. from UCLA, graduating Phi Beta Kappa at age 18. Three years later he was awarded his J.D. degree from Harvard University Law School. He joined a Los Angeles law firm in 1949 where he specialized in tax and corporation law and remained until 1955 except for service as a U.S. Army legal officer during the Korean emergency. He joined Hunt Foods and Industries Inc. in 1955 as associate tax counsel. He subsequently became tax counsel, vice president-finance and executive vice president. In 1964, he became president of Hunt-Wesson Foods Inc. In 1968, he was elected president of Hunt Foods and Industries Inc. and with the formation of Norton Simon Inc. later that year — resulting from consolidation of Canada Dry Corporation, Hunt Foods and Industries Inc. and McCall Corporation — he was named chairman of the new company's finance committee. In 1969, he assumed the additional post of chairman of the board of Norton Simon Inc.

Mr. Williams served full-time as energy coordinator for the City of Los Angeles during the 1973 energy crisis. While at UCLA, he also was director of Norton Simon Inc. Phillips Petroleum Company, ARA Services Inc., CNA Financial Corporation, Signal Companies Inc. and Montgomery Street Income Securities, and a trustee of the Aerospace Corporation. In his service to the community, Mr. Williams has been co-chairman for the Public Commission on Los Angeles County Government, a subcommittee chairman of the mayor's *ad hoc* Committee on Los Angeles City Revenues, a member of the State of California Commission for Economic Development and of the California Citizens Commission on Tort Reform, and a member of the SEC Advisory Committee on Corporate Disclosure.

Irving S. Shapiro is chairman of the board and chief executive officer of the Du Pont Company, the world's largest chemical firm.

He came to Du Pont in 1951 as an attorney in the legal department after serving for eight years in the Department of Justice during the Roosevelt and Truman Administrations.

In 1965 he was appointed assistant general counsel of the company. He became a vice president, director and member of the executive committee in September 1970 and was designated a senior vice president in January 1972.

In July, 1973, Mr. Shapiro was named vice chairman of the board, a new position that made him the second ranking officer of the company behind Chairman Charles B. McCoy. In the following December, he was named as Mr. McCoy's successor.

Born in Minneapolis, Minn., the oldest of three sons of Lithuanian immigrants, Mr. Shapiro graduated from the University of Minnesota with a bachelor of science degree in 1939. Two years later, he received his bachelor of laws degree from the same university. He was admitted to the Bar in Minnesota in 1941 and in 1944 was admitted to practice before the United States Supreme Court.

He is a director of International Business Machines, Citibank and Citicorp, the Bank of Delaware, Continental American Life Insurance Company and Greater Wilmington Development Council.

He is on the board of trustees of the University of Minnesota Foundation and on the board of trustees of the University of Delaware. He is also a member of the board of directors of the Associates of the Graduate School of Business Administration of Harvard University, the visiting committee of the John F. Kennedy School of Government of Harvard University, the board of trustees of the University of Pennsylvania, and the board of governors of the University of Pennsylvania Law School.

Mr. Shapiro is an American director of the U.S.-U.S.S.R. Trade and Economic Council Inc. a member of the Advisory Council on Japan-U.S. Economic Relations, and a founding member of the board of governors of the Jerusalem Institute of Management in Israel.

Mr. Shapiro is a trustee of The Conference Board and the Ford Foundation. He was elected chairman of The Business Roundtable in June 1976 and served in that capacity for two years. He is a trustee of the Academy of Natural Sciences, and a member of the American Academy of Arts and Sciences, the Business and Professional Friends Committee of the National Center for State Courts, and the executive committee of the Coalition for Adequate Judicial Compensation.

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Corporate Accountability and Corporate Power

by
Harold M. Williams
Chairman, U.S. Securities and Exchange Commission

In an essay only recently discovered, Albert Einstein describes what he characterized as "the happiest thought of my life." That idea was basically the recognition that out of seeming contradiction, inspiration and creativity often flow. Einstein derived this proposition from his struggle to rationalize Newton's theory of gravitation and his own concept of relativity. He was able to reconcile both theories as a result of an obvious, if startling and far-reaching, insight — that a person falling from the roof of a house is both simultaneously in motion and at rest. He wrote:

> For an observer, in free fall from the roof of a house, there exists, during his fall, no gravitational field . . . in his immediate vicinity. If the observer releases any objects, they will remain, relative to him, in a state of rest. The observer is therefore justified in considering his state as one of "rest."

Although this hypothesis is superficially unreasonable and contradictory, it has in it the seed of a superior and powerful logic which can accommodate both Newton's view and Einstein's in the same overall conceptual scheme.

The notion that the reconciliation of contradictions may be the impetus to creativity is one which, I believe, is also relevant to the topic of these lectures — the struggle to rationalize the various views towards corporate accountability and corporate profitability. At minimum, if contradiction is the stuff of creativity, then there is certainly abundant reason to hope for intellectual progress in this area. Moreover, as in Einstein's hypothesis, different conclusions may simply reflect differences in the observer's own position. The debate over the relative merits and abilities of inside and outside directors, differing views of the balance between the private and quasi-public responsibilities of corpora-

tions, and disputes concerning the proper role of the shareholder in corporate accountability all suggest that the subject is sufficiently complex and multifaceted that a wide range of contradictory theories, each with its own grain of truth, can be distilled from the experiences and preconceptions of different observers.

Perhaps the most basic contradiction is the high level of interest, on the one hand, in greater government-dictated control over what our large corporations do, and on the other hand, the strong current of public sentiment for less government involvement in all facets of private activity. I am not optimistic that this particular contradiction will necessarily resolve itself in business' favor. Present economic problems — particularly inflation, unemployment, and energy — may damage American business much more than the regulatory reform movement will aid it. The American people cannot experience disappointment in their economic goals and aspirations without reacting negatively against American business. The tendency is to assume that if economic expectations are not met, the cause is that business — the vehicle of our economic progress — has somehow channelled its power to serve its own ends rather than the public's. If this seems implausible, consider the recurring suspicion and hostility toward the oil companies and the way it clouds and confuses the ability or willingness of the public and the politicians to conclude that the energy problem is real and to perceive the role of the oil and gas companies in the solution.

I would, therefore, like to take as my theme today the way in which this contradiction can be resolved consistently with both public expectations concerning the accountability of corporate power and with the health and stability of our private economic system. While the search for such a resolution will not be an easy one, in my view, the only hope for an answer consistent with private enterprise lies in the ability and commitment of the private sector to take the initiative in structuring effective mechanisms of corporate accountability. During the past decade, the ability of business to shape the issues and to limit the governmental response to that which is logical and consistent with the continuation of a healthy and vital private sector has been limited, at best. And, at the same time, there has come to be a growing public sense that business no longer attempts to balance its interest and the public's, but rather focuses entirely on its own narrow objectives.

The findings of one firm which has done extensive work concerning public attitudes toward business illustrates this skepticism. In 1968, Yankelovich, Skelly and White found that 70 percent of the respondents in a national survey agreed that business tries to strike a fair balance between profits and the public interest. Only two years later, in 1970, that figure had dropped to one-third. It reached a low point of 15 percent in 1976 — an 80 percent loss of support over eight years. And, it has not recovered significantly in the years since 1976, with readings of 15 percent again for 1977, 17 percent in 1978, and 19 percent in the most recent survey. Similarly, in 1978, only 15 percent of the public regarded corporate executives as "very credible;" 36 percent considered them "not credible." On the other hand, one of business' best-known critics, Ralph Nader, received a 44 percent "very credible" rating — the highest of any person or group in the various categories surveyed. Television commentators, at 40 percent, were close behind.[1]

If these survey results, and others like them, are an accurate reflection of confidence in our private economic system, then it is not difficult to understand why the political process frequently seems insensitive to measures which would improve the health of the private sector. And, correspondingly, it is these kinds of perceptions of business and its leaders which business needs to change.

I. The Issue — The Accountability of Power

At the outset, it is useful to explore why the accountability of corporate power is an issue in our society today. Quite clearly, the American economic system has propelled us, in less than 100 years, from an underdeveloped, primarily agricultural country, to a society of mass wealth and mass consumption. In the process, we have raised the standard of living in much of the rest of the world along with our own. This unprecedented phenomenon is a direct result of our private enterprise system. Moreover, wherever countries of comparable resources are compared, the economy with a significant private sector has clearly done more in fulfilling the aspirations of its people than its nonprivate counterpart. Compare, for example, West and East Germany, South and North Korea, or Austria and Czechoslovakia. In the face of this tremendous success, why should any question arise as to the "accountability" of corporate power? A more natural reaction would seem

to be, in the words of a former Office of Management and Budget director, "If it ain't broke, don't fix it."

A. The Demand for Accountability

In my view, the answer to this particular contradiction lies in the fact that we have a deep-seated conviction that anyone who exercises power needs to be accountable to someone else for his stewardship. Most people would, I think, regard it as self-evident that anyone who is not accountable, whose word is final and who is not subject to review and risk of removal for failure to achieve acceptable results, may, over time, become autocratic, arbitrary and arrogant. History teaches that the unfettered exercise of power will often tend to result in a loss of contact with reality, insulation from unpleasant news and increasingly insensitive and irresponsible judgments. The institution becomes an end unto itself, out of touch with its relationships and its responsibilities to the rest of society. Such a situation is destructive of the institution involved and those it impacts and is morally unacceptable.

There is a concern on the part of too many to ignore that this syndrome can and is occurring in aspects of American business. The question then is whether the structure of accountability in which modern corporate management operates is adequate, in both theory and practice, to meet that concern. And, to a degree, the issue is not whether corporate power is, in fact, frequently abused to the detriment of the public. Rather, the crux of the problem is whether the public can reasonably perceive that to be the fact. Business would be well-advised to bear in mind this distinction between reality and public perception as the debate over corporate accountability proceeds. Over time, no activity can flourish if "the public" takes a dim view of it. Over a longer term, no activity can continue unaltered if public apathy or distrust become active antagonism.

B. The Withering of Traditional Checks

I do not believe there was ever a golden age when business was admired or accepted — or even well-understood — by the majority of any society. In the minds of many morally-sensitive people, markets have always been regarded as inhumane and unjust, and often even capricious. Efforts to improve one's position have been regarded as socially disruptive, and trade as less honorable than other occupations. Traditionally, however, two

answers have served to alleviate concern over the question of whether economic power is accountable.

The first prong of the response has been that the discipline of the marketplace checks, and ultimately destroys, those who are irrational in the exercise of corporate power. Whatever force it may once have had, however, this hypothesis has lost most of its vitality — at least for the largest corporations. The difficulty is that the theory presupposes an open economic universe which is no longer the reality. We have substituted for that open universe of free competition a business environment designed to insulate against the hazards of a 19th Century economy. In fact, even what is left of the argument that the discipline of Wall Street will ultimately result in an inadequate management's replacement is being rapidly impaired by corporate defensive charter amendments and other similar measures which, in many cases, effectively eliminate the discipline imposed by the possibility of an unfriendly takeover. While some have questioned their efficacy, charter amendments requiring super majorities to alter corporate by-laws, the staggering of director terms of office, and similar devices serve to insulate management from the possibility of ouster by an outsider — regardless of the performance of management or the price the outsider is willing to pay.

Overall, this new economy is a combined private and public one with a myriad of risk-minimizing devices. This development may well be inevitable, given the social disruption which the collapse of a Lockheed or a Chrysler would spawn. The point, however, is that in such an environment, an appeal to free enterprise as a justification for the lack of formal checks on corporate power is largely rhetoric used to preserve the autonomy of management rather than a significant comment on issues of public policy. Too often businessmen have been willing both to use that rhetoric when it serves their purposes and to seek protection from the perils of the marketplace when it does not.

The second argument most commonly used to challenge the need for mechanisms of corporate accountability rests on the theory that the board of directors, as the shareholders' surrogate, acts as the watchdog of management power. Again, however, the facts do not adequately support the theory. While the record of board performance is difficult to isolate and study, it shows that directors seldom turn ineffective management out and react exceedingly slowly to corporate deterioration. Boards have occasionally asserted themselves, but such activism is rare, though

increasing significantly. In this testimony before the SEC on September 30, 1977, Myles Mace pointed out that, for example, when boards have fired a chief executive,

> the leadership of the [incumbent] was so unsatisfactory that even his mother thought he ought [to go] for the good of the company . . . before the board reluctantly moved.

Correspondingly, stockholder discontent is more frequently reflected in the sale of the company's stock rather than the rejection of its directors at the annual meeting.

As a result, it is possible in many companies for management to limp along until either economic setbacks are so severe that change is compelled or until a large investor or company, recognizing that the corporate assets can produce better profits, wrests away control. In the former case — when reported profits decline to such an extent as to threaten the security of their position — some managements are tempted to change the accounting practices, earnings figures, or morals of the company in order to delay the inevitable by presenting a more acceptable profit picture. And, in the latter case, by making a bid for control more difficult, we neutralize one of the remaining disciplines on corporate management.

What is missing from this environment is a force that has the practical capacity to effectively oversee management, and if necessary, make timely changes. To the extent that the public perceives this accountability gap — and concludes that it has suffered serious consequences because of it — the pressure mounts for government to be called. I have little confidence, however, in government's ability to be prescriptive concerning corporate mechanisms without also being so oppressive as to destroy them. Thus, in looking for solutions, we need to concentrate on improving the overall effectiveness with which the present system functions, rather than experiment with a totally new system of accountability. The issue is how to preserve the advantages of a strong management-based corporate system and still be assured of effective institutional discipline. In my view, the answer is to be found in the corporate board room.

II. The Role of the Board of Directors

A strong and effective board is a valuable corporate asset. Enhancing the perception of corporate accountability and thus reducing the pressure for a government role in corporate de-

cision-making is a vital goal. However, both management and directors also share another, more fundamental, goal — to develop a board which can bring the best, most informed and most objective advice available to bear in solving the complex problems which confront the company and American business today. If directors are timid or feel compelled to compromise rather than advocate their views forthrightly — whether because of their personalities, their friendships, or their pocketbooks — then, in the long run, the corporation is the loser. And the officers and directors may be the losers as well, since they may not be able to point to the kind of disinterested decision-making which underlies the business judgment rule. Viewed in this light, the benefits in terms of public credibility which would flow from more effective accountability are secondary to the value which the corporation can derive in practical, day-to-day terms from a vigorous and thoughtful board.

In suggesting that an independent source of discipline is missing from many corporate environments, I do not mean to ignore the very real progress which many boards have made. Indeed, some boards already function most effectively, and many others are exploring ways to strengthen their role. The changes that the board is undergoing, or has undergone, have served to protect the basic system and to demonstrate its ability to evolve. As I will outline in a moment, I believe the basic sociology of the board room dictates that those companies which are not already engaged in a searching examination of the role their boards could play should do so, and that further changes should occur. These changes are, however, within — not destructive of — the basic board framework.

It is important to recognize that board reform proposals — which some in the business community regard as radical — appear in a different light to many outside. For example, Professor Lewis D. Solomon, in his March 1978 *Michigan Law Review* article concludes:

> . . . [T]he problem of corporate reform is too complex and intractable to respond to so simple a solution as the reform of corporate boards. Our efforts to revive the board of directors are simply anachronistic; new methods must be devised if we are to make corporate management genuinely accountable.[2]

And, Peter Drucker, an academic, but certainly not an antibusi-

ness ideologue, characterized the board of directors as an "impotent ceremonial and legal fiction."[3]

I do not personally share in the more cynical implications of these observations. On the contrary, I believe that the board of directors is the key mechanism within the corporate structure which can render unnecessary any efforts to impose accountability from without. But, as the comments of Professors Solomon and Drucker illustrate, it is by no means a foregone conclusion that boards will be able to reverse the trend of public skepticism toward the exercise of corporate power. Nor can I say that their skepticism about the way many boards function is misplaced. I do disagree, however, with the premise that the board, as an institution, cannot be made to work effectively, and disagree vigorously with the various proposed solutions which, in my judgment, propose a new disease worse than that to be cured. In my view, the board can serve to institutionalize effective accountability without bringing the hand of government down upon the corporate structure.

A. The Sociology of the Board Room

In order to fill its role, the board needs to focus on the sociology of the board room and to re-examine the role of the board and the individual director. Each board and board room is a mini-society. In some of these societies, the board is strong and effective. In others, it is passive and reactive. When a person becomes a member of the board, he must decide what his relationship will be to that society. If the mood — the social ethic — is one of disinclination to criticize, if directors are expected to ratify management decisions, and if inquisitiveness is interpreted as distrust of the chief executive and a violation of good corporate manners or protocol, the system breeds a tendency to rubber-stamp management, make comfortable decisions, and avoid confronting signficant issues as long as possible.

When it occurs, this sociological climate derives not necessarily or alone from a quest for power or a management desire to be free of the discipline of oversight, but rather from two very normal, benign human traits. First, management tends to invite on the board people who are compatible, if not indebted, to the corporate chief executive officer and the management. Inside directors are the most extreme case of this phenomenon. Corporate employees *cum* directors depend on the chief executive, not only for their tenure on the board, but for their promotions

and salaries, and are therefore disinclined to challenge him or management recommendations. Insiders can, of course, perform useful service on corporate boards. They can furnish information and perspective to outside directors, afford outsiders a first-hand opportunity to appraise management, prevent a chief executive from painting an unrealistically favorable picture of corporate performance, and make board decisions more palatable to their fellow corporate executives. But insiders cannot, by definition, perform the functions of holding management's exercise of corporate power accountable.

Outside directors — that is, directors not simultaneously employees of the corporation — may suffer from similar limitations. Outside directors also often depend on the chief executive for their position on the board and frequently have personal and business reasons for agreeing with him. Outside directors are often friends and social acquaintances of the chief executive or from the upper echelons of companies and professional firms patronized by, or otherwise economically concerned with, the corporation. The social and professional connections may overlap. They often do business together and are involved in the same community, charitable and social organizations.

A second factor which works against board effectiveness is the tendency of people who work together over a period of time to seek to create a tension-free, harmonious environment. This tendency pervades human society and, indeed, makes society possible. But in the context of the board room, one of its consequences can be that, over time, the management's accountability to the board declines. Accountability, and the discipline it entails, threaten to upset the comfortable, harmonious relationships which we all tend to move toward.

We cannot ignore the consequences of these two factors — the tendency to select compatible directors and the avoidance of tension or discomfort. They represent a constant pressure to make the atmosphere in the board room congenial and to transform directors into sympathetic listeners rather than independent inquirers. Accordingly, we need to search for ways to institutionalize other pressures which will keep compatibility and accountability in equilibrium. The goal is not to transform managements and directors into adversaries, but rather to make sure that the board's effectiveness does not gradually erode in response to the pressures under which it operates.

B. Creating the "Ideal Board"

In speeches during the past several years, I have made a number of proposals concerning board composition, chairmanship, and committee structure which would, I believe, help to counteract these tendencies. The board construction I have proposed addresses what I consider to be the most common and objectively identifiable aspects of board structure and composition which can impede the effective functioning of the board. It obviously cannot deal directly with the matters that ultimately determine board effectiveness — the sociology of the board room directly and the personal qualities of individual directors, whatever they may be. Yet, ultimately, the effectiveness of the board is determined by those very factors — the attributes of the directors and by the attitudes and ethics which pervade the board room.

For that reason, rather than repeat my board structure proposals, I want to outline the concerns which underlie them. My objective is to encourage boards to explore the issues and their implications and relevance to them.

First, it is important to consider the role and number of insiders on the board. By this I mean individuals who are either employees of the corporation or otherwise dependent upon it economically. That definition requires boards to focus on many traditional directors in addition to employees, such as corporate counsel, underwriters, bankers, major customers and major suppliers. I am not suggesting that these individuals are necessarily ineffective as directors or that self-interest usually clouds their judgment. As I pointed out above, however, the sociological and psychological factors which pervade the board room limit the ability of management members to perform the accountability function. Similarly, the "second hat" which corporate counsel and other "suppliers" wear with respect to the corporation raises an issue of whether their ability to contribute to both the reality and the perception of accountability is diminished. Stated differently, directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether that cost is a necessary one to incur, and whether the benefits can be achieved in other ways.

Second, boards need to examine the role of the corporate CEO as chairman of the board. The ties which board members will feel to the CEO and their basic desire to be supportive are compelling. The consequences of adding to that power the power of the

chair and of the agenda process must be weighed cautiously. The point is not that chief executives are untrustworthy when they hold the office of board chairman; in fact, the capability and integrity of the chief executive officer ultimately determines the success of the company. If the board or individual board members reach a point where they do not trust the CEO, they should either replace him or resign. Nonetheless, the intimidating power of the chair, especially when occupied by a chief executive to whom many on the board owe their directorships and perhaps their livelihood, is a factor which deserves serious consideration. Moreover, in the board environment, the role of the chairman and that of the CEO are not the same. The chairman's role is to create the kind of open, contributing and questioning environment which I have described. The CEO's role is to speak for management. These roles are not the same and can conflict.

The final broad issue which boards must consider is the specific responsibilities which the board needs to discharge and how best to approach these tasks. Board committees comprised of outside directors may have an important role to play in that process, especially when there are a significant number of insiders on the board as a whole. Audit, nominating and compensation committees are particularly crucial. Audit committees are critical because of the fundamental role which the independent auditor plays in corporate accountability and the special trust which the public places in the auditor's work. With the wide acceptance of the concept of the audit committee, the next question which must be faced is the definition of the committee's responsibilities. At present, many audit committees are, undoubtedly, not yet working fully effectively, and some may serve more to provide window-dressing rather than to add substance to the accountability process. The development of a better consensus as to the minimum responsibilities of audit committees should be an important priority.

A second important mechanism — one less widely recognized — is the independent nominating committee. For such a committee to be effective, it must concern itself with board composition and organization. It can thus be the vehicle to deal more objectively with the trade-offs between the benefits of, for example, management representatives on the board and the costs of those representatives. As long as such decisions are in the hands of knowledgeable, concerned independent outsiders, I believe that the environment for the kind of accountability which I have been describing will be substantially enhanced.

More broadly, however, the most important responsibilities of the nominating committee should be to develop a process to assess how well the board is functioning, to evaluate the board and its members, and to select criteria for board candidates which mesh with the board's needs. For example, the nominating committee may legitimately look to other companies as a source of additional board talent. CEOs, because of their background, bring to boards the kind of perspective and experience which is desirable in assessing what the company is doing and where management proposes to take it. CEOs, and some other individuals with experience as members of a corporate senior management team, can also appreciate the concerns and the perspective of the company's CEO and the inherent separation between management and the board. At the same time, however, nominating committees should not conclude that only individuals with corporate experience — those who have met a payroll — qualify for board membership. Researchers, scientists, academics and many others may also have a valuable contribution to make toward achieving the company's objectives.

An effective compensation committee will also strengthen accountability. In addition to considering the appropriateness of the compensation packages for senior management, such a committee should, for example, examine key management compensation policies to assure consistency with the long-term interests of the company and to assess whether compensation practices encourage management to maximize short-term profit at the expense of long-term interests. Another aspect of this committee's mandate should be to consider the level of director remuneration. Compensation for directors is growing — and properly so. The non-monetary rewards of these posts, such as the prestige and the desire to do the board or its chairman a "favor," are not now as compelling — particularly when weighed against the increasing time demands and the risks of liability and other legal entanglements. Directorship is a responsibility rather than an honor or a courtesy, and should be regarded and compensated accordingly. All of these considerations should be elements of the compensation committee's work.

C. The Limits of the Board

Before I turn to the role of management in the accountability structure, I want to outline what I do *not* advocate for the board, since critics of my views seem to have a tendency to attribute

positions to me which I have not taken. First, I do *not* favor constituency directors. In my view, the board is not a political body and cannot function effectively when populated by individuals who have special interests to champion and little concern or sense of responsibility for the overall welfare of the company. Additionally, some of those who advocate constituency directors seem to have in mind persons unconcerned with — or actively hostile to — the basic economic purpose of private business. For those reasons, I strongly oppose constituency directors.

Second, I do *not* desire or intend to convert the board room into an arena characterized by distrust of, or suspicion toward, management. I have sometimes used the word "tension" as a characteristic of the relationship which I visualize between management and the board. For some, this conjures up certain images I did not intend. The goal is an environment of accountability — not one of hostility. A chronically adversarial relationship between board and management would be equally as destructive of accountability as is a relationship characterized by board passivity. The board and management must be capable — within the accountability framework — of working with, not against, one another.

Third, I *oppose* federal legislation or regulatory action to charter corporations, to dictate board structure, or even to impose my own suggestions. My goal is to highlight my sense of urgency that corporations, their managements and boards assume the initiative in assessing the responsibilities of corporate boards and how they might better be carried out so as to strengthen the case against legislation, and make it unlikely — not to hasten its passage. While some apparently believe that legislation is the key to reform, I am concerned that federal encroachment into the board room would likely cripple rather than strengthen its functioning.

Legislation would, I believe, be crippling for two reasons. First, a statute will, by definition, impose one solution on all corporations. The flexibility to tailor the board to the needs of the particular corporation would vanish. Second, legislation which sought to mandate "independent" boards or "independent" directors would of necessity focus on structure, form, and objective criteria, rather than on the intangibles that ultimately determine how well the board discharges its responsibilities. It would have the effect of diverting attention from the efforts of individual companies and boards to discharge their responsibility to do whatever is necessary to make their boards effective and of fo-

cusing it instead on mechanical compliance with the law. The legislation would not be effective, the consequences would not be desirable, and would likely spawn further, more restrictive, legislation which may ultimately preclude both the possibility of boards functioning effectively and the ability of managements to deliver the results necessary to assure our economic and political future.

Finally, I am *not* suggesting that the board's power over corporate business expand at the expense of management's. The appropriate and most productive function of the board is to monitor, not to manage — to support, to guide, and where necessary, to discipline, but never to usurp. To the extent that effective functioning of the board cuts back on management autonomy, the board is assuming a role it had previously abdicated — not usurping a management prerogative.

III. The Role of Management

I want now to turn to corporate management. In the debate over enhancement of the corporate board, it is easy to lose sight of the fact that the success of American business and its contribution to our nation's future economic health will continue to depend primarily on the ability and effectiveness of corporate management.

A. Management and the Profit Objective

In considering the role of management, it is crucial to recognize at the outset that management's primary mission is economic and that the key to the success of any corporation is the capability of its management to carry out that mission. The purpose of the corporation is to provide customers with goods and services at an attractive level of quality and price. The profitability of the corporation is, over the long run, a measure of its success in discharging that underlying responsibility, rather than an end in itself. The profitability of corporations as a group is a measure of our society's success in providing jobs, goods, services, prosperity and other economic underpinnings of the political freedoms which make our democracy possible.

It is the quality of managerial leadership, its willingness to venture, take risks and seek rewards, which will determine the future of individual businesses and of the economy as a whole. No government rule, no board of directors, no federal agency,

can offset the consequences of an inadequate management — and all of these must guard against usurping the management role or crippling an able management. Because, however, of these and other pressures on business executives, there is always a danger in today's climate that some managements of their own volition will not risk being second-guessed or failing and will tend to "play it safe" at the expense of the primary economic mission. Such an approach is not consistent with the kind of risk-taking ventureomeness necessary to the future of American business and the American economy.

In opposition to proposals to change the accountability framework in which corporations operate, the argument is sometimes made that the entity is accountable to its shareholders and that their interests must be paramount. In my view, that concept is correct, but the definition of shareholder which its proponents use is not. The "shareholder" to which management should regard itself as accountable is not simply those individuals who happen to be shareholders today — or at any arbitrary point in time — but to "ownership" as an institution over time. When the "shareholder" is viewed as a continuing, long-term group — even though its membership is changing daily — there is far greater congruence between corporate activity in the interests of its shareholders and the interests of the larger society. Concern for how a company can contribute over time to serving today's needs for goods and services in a competitive economy is an effective antidote to the tendency to make expedient short-term decisions.

B. Profits and Business Ethics

Given that profits are a management's most fundamental responsibility, the question arises to what extent pursuit of that goal is to be impacted by ethical standards and, if so, how these standards are to be established. Here again, there are those who look upon the corporation as engaged in activity which is essentially economic, and as such, to be judged by its success in the marketplace, limited only by its obligations to obey the law.

Simply stated, good management concerned for the future of the company achieves a harmony of profit and other goals; indeed, there is a very strong correlation between companies which think and respond in terms of longer-range corporate responsibilities, including social and political overtones, and those with the best performance records over time. The converse is also

true. Managements which fail to think in terms of the broader social dynamics in which they operate are unlikely to anticipate changing customer needs and therefore are not likely to prove successful over time.

It is clear to me that individuals functioning in a corporate capacity — both individually and collectively — have as great a responsibility to conduct themselves ethically as they do in their personal lives. They do not and cannot absolve themselves of that responsibility by assuming a corporate mantle and by asserting that their efforts should be judged in economic and profitability terms alone. As a practical matter, it is the individual who must be held accountable — not some amorphous thing known as the corporation. The corporation has no morality or immorality, no values or ethics, separate from those of the individuals who make it up. Actions attributed to business firms are performed by individuals, and they should be considered personally responsible for whatever business firms are accused of doing. It is the individual executive who decides whether to act morally or immorally, ethically or unethically. Consequently, it is impossible to separate the social environment of the firm from the ethical standards of the executive who manages it. The executive inevitably finds that his own moral code is the bottom line in his business decision-making, and it is not realistic, either psychologically or ethically, to expect the individual executive's actions as a businessman to be inconsistent with his personal sense of responsibility to society at large and to his own conscience. To contend that one can live a personal life by one set of ethical standards and a business career by another is either self-deception or hypocrisy.

Management, however, frequently and unwittingly creates a climate that tempts subordinates to compromise their ethics — not on their own behalf, but on behalf of the company and the company measurement of performance. A company, in order to be prudent and moral, must be careful to avoid creating ethical conflicts for its employees. One management, in the course of developing a code of conduct for its employees, was shocked to learn from them the number of people in the firm who had faced a wide variety of serious ethical dilemmas and handled them on a case-by-case basis with no guidance from top management. But more importantly, most cases had been resolved in favor of the course that would produce the greatest short-term profit. Management discovered that a number of expedient practices had

been prevalent because of two employee attitudes. First, the company was perceived as always having placed great emphasis on rewarding those who made the largest contribution to profits. Second, the firm had never evidenced any special concern for ethical standards. Consequently, most employees naturally concluded that cutting corners in order to maximize profits was a condition of employment.

The lesson of this example is that top management must set the moral tone in any organization, and it must personally see that the staff remains on course. If the standards of top management are high, the chances are excellent that the standards throughout the organization will be equally high. But if those at the top do not have high standards, or if they violate the standards, there is an ever-present danger that more honorable persons below will be influenced by attitudes of those above them, and the organization's tone will reflect it. Subordinates quickly discern the standards of their bosses and tend to act accordingly. Thus, do not be surprised to find that if you permit a man to steal *for* you, he later steals *from* you.

This is the core of the debate over corporate accountability. If an individual is in a business setting in which every action is justified on purely economic grounds and in which rewards and punishments are based on short-term economic performance, then, quite naturally, he will shape his conduct to maximize the economic returns of the entity, even at the expense, if need be, of other social or ethical values. The result may be positive in the short run. Over the longer term, however, business may destroy itself if it pursues that course. I do not believe society will tolerate, permanently, a major institution in its midst which justifies itself solely on economic terms. Nor do I believe that people who staff the entity will be able, indefinitely, to pursue conduct in their business relationships which is not consistent with other dimensions of their lives.

IV. Initiatives Toward Private Sector Leadership

I stated at the outset that my theme today was the need for the private sector to assume the leadership role in corporate accountability. That challenge — which is independent of the specific board structure proposals — should be the concern of every member of the business community. In the last analysis, the future of the private enterprise system will be, and is being, determined every day in the board rooms of America. Boards will

decide, issue by issue, how to allocate resources, when to venture and risk, whether to act in an expedient manner in the shortsighted interest of the company, or whether to seek solutions consistent with the longer-term interests of the company and with preserving the system. But even though the board room will be the decisive battleground in the struggle to retain the initiative over corporate accountability within, rather than without, the private sector, there are significant steps which business and professional leaders can take outside the board room to influence that struggle.

First, the private sector can provide more and stronger leaderships for itself through its own existing organizations — such as the Business Roundtable and the Conference Board — or new ones especially formed for the purpose. The task is not an easy one, since the objectives of such groups must orient more toward providing leadership, rather than building consensus, if they are to be effective. Individual businessmen and associations of businessmen should speak out on the standards of business — not as defenders of business whether right or wrong, and not from a parochial view of a trade or industry association. Rather, businessmen should seek to develop standards to which all business would be expected to subscribe. To the extent that the private sector can establish the bench marks of what is right or wrong, it is more likely to be able to prevent legislation of the type on which the public will insist if self-policing is perceived to be ineffective. More broadly, the picture of business leaders taking strict positions on business standards can provide a vehicle and a direction for restoring public confidence in the role of business in our society.

Second, business leaders should encourage the stock exchanges and other formal self-regulatory bodies to continue to provide leadership regarding minimum standards of accountability. The New York Stock Exchange, for example, has taken an important first step in this area by requiring audit committees of outside directors as a condition of listing. Other self-regulators are considering similar action. Although there is tremendous potential, there has not been enough systematic focus in the corporate community on the role which self-regulatory bodies could take in pre-empting the need for legislation.

In fact, the time may arrive to create a new private sector self-regulatory body with the enhancement of accountability and the articulation of the minimum norms of corporate conduct as its

exclusive function. This is not a model with which we have had much experience. Yet, voluntary bodies — for example, the National Advertising Review Board — are functioning in other areas. A corporate accountability body, formed in and by the private sector, might serve as an effective means to return the initiative to business. Lest the reports of this talk characterize me as advocating a formal self-regulatory body to regulate corporate conduct, let me make it clear that that is not my objective. I am trying to stimulate the ingenuity of the private sector — which will be brought to bear once it is convinced that a problem exists that needs solving — to devise creative and effective institutional methods to assist in achieving the desired result. Ultimately, I hope that through these efforts and others, we can reach a point where, for example, the meaning and importance of what constitutes an independent board is well-established, and its significance so clear that a company will be compelled to respond to its peers, investors, lenders, analysts and others if it does not appear to conform to the prevailing standard.

Third, business needs to find better ways to articulate its concerns and to describe its efforts to respond to the need for better accountability. Where systematic progress has been made, we should not be reticent to publicize it. While the focus of this paper is on the need to improve corporate accountability, there are many examples of effectively-functioning boards and of efforts to improve — more so than advocates of change are willing to acknowledge. This needs to be communicated to shareholders and the public at large. Similarly, where business can make a case that particular regulations or legislative proposals will hamper it in discharging its responsibilities to the national economy, business leaders should not be reluctant to present their point. While business' credibility is sometimes suspect, there can be little hope of educating the public if the effort is not made.

Fourth, professionals, whether they be lawyers or accountants, both individually and through their firms and associations, should be involved in informal standard setting. Lawyers, for example, have always been in the vanguard of any discussion about the role of corporations. Even though the most significant issues concerning corporate and shareholder conduct are policy questions which do not turn on the interpretation of legal rules, lawyers play an important role in shaping that conduct. Counsel to the corporation has influence which goes well beyond providing answers to technical, legal issues. He is, in fact, a policymaker. His

professional training should equip him to raise ethical questions and he should be questioning his client about the appropriateness of its conduct. Similarly, if history is any guide, new corporate models and structures, responsive to the need to harmonize the expectations of society with its economic goals, will be shaped largely by lawyers. Thus, lawyers have an important role in guiding private sector accountability initiatives.

Further, institutional shareholders have a part in vitalizing accountability. At present, individual shareholder participation is not particularly effective. Many shareholders are primarily speculators in the income stream of the corporation. They are interested — so the argument goes — primarily in the short-term performance of the corporation, and if they are not satisfied, they will react by selling their stock. In other words, such shareholders do not behave as long-term owners.

At the same time, however, the role of financial institutions as the major stockholders of larger American corporations is growing. Their voting power is such that they cannot realistically be neutral on matters that call for shareholder consideration. Short of a decision to sell the stock, what are the obligations of institutional investors? Do they routinely support the corporate recommendation, do they vote their own judgment, or do they abstain? Any course can strongly influence the board's and management's attitude and the result.

Finally, business must do a more effective job of relating to government. Government needs to have a better understanding of the impact of social legislation on business and of the price which is paid in terms of productivity, innovation, and capital formation when regulatory schemes nullify the rewards which have traditionally flowed from risk-taking. The job is not an easy one since business' input will be seen as self-interested and suspect. Nonetheless, this is an area in which government has a desperate need for information which business can best supply. Business will be more credible, of course, if it also takes stands which do not serve self-interest. This is a task to be undertaken by business leaders — by CEOs — not by the corporate governmental affairs officers alone, and one which can only be effective when part of a continuing program commenced long before a particular problem has escalated to crisis proportions.

V. The Role of Government

That thought brings me to the facet of corporate accountability which I want to touch on last. Although, as I indicated earlier, I am opposed to legislation which would dictate the parameters of corporate accountability, I do believe that government has a role to play in the evolving accountability process. The struggle between government and business has become so deep-seated that many have come to perceive them as natural and permanent antagonists. However, if government and business are seen as natural enemies, then business as we know it has no long-range future. Government, as the only social institution that can legally enforce its will, must win any struggle if the issue is reduced to one of power.

A more realistic and constructive approach to the relationship between corporate accountability and government would begin by identifying the many ways in which business and government depend on each other. For example, modern business requires a level of social order and enforcement of the rules of the game that only the state can provide. Similarly, government, in our society, depends on business as the instrument of economic policy — the employer, producer and taxpayer — which makes possible achievement of our society's economic goals. If business is to continue to have this role, rather than have it usurped by government, it must have public trust in its integrity and legitimacy.

While I oppose federal legislation or regulation which would dictate corporate structure, the modern corporation is, in my judgment, partially dependent on the federal government's ability to create the tools with which public trust and legitimacy can be built. The federal securities laws are a good example. While it is not my purpose today to defend everything which the Commission and the courts have done under the banner of these statutes during the past 45 years, I believe that the philosophies of full disclosure and of fair and open corporate suffrage have helped to preserve public confidence in business. Obviously, the securities laws also impose costs — at times very heavy costs — on public issuers. These costs are, however, I suspect, small indeed compared to the costs which would have flowed from the substantive restraints which the public would likely have demanded if disclosure had not been adopted as the regulatory framework in 1933 and 1934.

I do not pick the federal securities laws as my illustration because I believe they are flawless. I do think, however, that they highlight a reasonable role for government in creating a framework in which corporations can build public trust. If the tide swings in favor of corporate governance legislation of the type which some proponents have discussed, I fear that government's role with respect to the accountability of private corporate power may take a very different and more substantive tack.

Government, for its part, needs to appreciate the consequences of substantive corporate accountability regulation and the likelihood that such regulation would not achieve its intended purpose. Regulation in this area would, in my judgment, focus attention on private sector compliance with the form of government rules and regulations, rather than on how to get individual boards to function effectively. It would convey the message that boards that conform are "effective" and those that do not are "ineffective" — judgments which may bear no relationship to reality. When events prove that the legislation itself was ineffective, attempts would be made to tighten it up. There is little history of government, once it starts down a legislative or regulatory road, acknowledging that its course was in error, repealing the legislation, and retreating. Even when it does, the intervening damage is usually heavy and difficult, if not impossible, to repair.

VI. Conclusion

I opened my remarks by urging that the private sector take the initiative in shaping the mechanisms by which the exercise of corporate power is subjected to accountability. Although much remains to be done, business has clearly made tremendous strides over the last several years, as the work of the Business Roundtable, the ABA Committee on Directors Responsibilities, and many other groups demonstrates. While I am deeply concerned that the time within which to move further toward this goal is limited, there are nonetheless certainly grounds for optimism. For example, Ken Andrews, in his *Harvard Business Review* article, "The Roundtable Statement on Boards of Directors," closes with the observation:

> The expressed willingness of the SEC and the possible assent of the FTC and the Congress to look to boards of directors as the legitimizing institution for the responsible use of corporate power are encouraging at a time when some critics are ready to rush into more regulation.

> The Roundtable report is now in the hands of the chief executive officers, board chairmen, and independent board members who may be moved to adopt its spirit and apply their own energy to deal with the residual tough problems it omits. In the interests of our economic system and continued corporate autonomy, I hope the Roundtable traces among its own members the progress of its precepts.[4]

Even if boards are fully successful in this legitimizing role, society cannot expect "zero defects." Corporate failures and instances of impropriety will still occur. Thus, the test cannot be the perfection of the result, but the integrity of the system and its ability to self-correct and self-police the inevitable breakdowns.

There is a moral tone in much of the criticism which has been levelled against business in the past. The central issue is integrity, and much will depend in the coming years on the forthrightness and courage with which business faces up to that issue. At the same time, however, America's economic vitality is its greatest asset. It is the product of the creative spirit of a free and industrious people and of an economic system that gives opportunity to private initiative. It is the foundation of our prosperity, our political freedom, and our constructive relationships in a world of peace.

Nothing which is done, either in the private sector or government, in the name of greater corporate accountability should be permitted to destroy that economic vitality. I am confident, however, that the contradictions and dilemmas inherent in the evolution toward more effective accountability can be resolved in a fashion which is consistent with — and indeed enhances — our economic strength. The challenge of finding those solutions, and pre-empting intervention from outside of business, is one which will demand the time, commitment and talent of everyone concerned with our economic and political future.

[1] Yankelovich, Skelly and White, *Report to Leadership Participants on 1978 Findings of Corporate Priorities* (1979).

[2] Solomon, *Restructuring the Corporate Board of Directors: Fond Hope — Faint Promise?*, 76 Michigan Law Review 581, 583 (1978).

[3] Drucker, *The Bored Board*, 1 Wharton Magazine 19 (1976).

[4] Andrews, *The Roundtable Statement on Boards of Directors*, Harv. Bus. Rev. 24, 38 (Sept.-Oct. 1978).

Corporate Governance

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The proper direction of business corporations in a free society is a topic of intense and often heated discussion. Under the flag of corporate governance there has been a running debate about the performance of business organizations, together with a flood of proposals for changes in the way corporate organizations are controlled.

It has been variously suggested that corporate charters be dispensed by the Federal Government as distinct from those of the states (to tighten the grip on corporate actions); that only outsiders unconnected to an enterprise be allowed to sit on its board of directors or that, as a minimum, most of the directors should qualify as "independent;" that seats be apportioned to constituent groups (employees, women, consumers and minorities, along with stockholders); that boards be equipped with private staffs, beyond the management's control (to smoke out facts the hired executives might prefer to hide or decorate); and that new disclosure requirements be added to existing ones (to provide additional tools for outside oversight of behavior and performance).

Such proposals have come from the Senate Judiciary Committee's antitrust arm; from regulatory agency spokesmen, most notably the current head of the Securities and Exchange Commission, Harold Williams, and a predecessor there, William Cary; from the professoriat in schools of law and business; from the bench and bar; and from such observers of the American scene as Ralph Nader and Mark Green.[1]

Suggestions for change have sometimes been offered in sympathy and sometimes in anger. They have ranged from general pleas for corporations to behave better, to meticulously detailed reorganization charts. The span in itself suggests part of the problem: "Corporate Governance" (like Social Responsibility before it) is not a subject with a single meaning, but is a shorthand label for an array of social and political as well as economic concerns. One is obliged to look for a way to keep discussion within a reasonable perimeter.

There appears to be one common thread. All of the analyses, premises, and prescriptions seem to derive in one way or another from the question of accountability: Are corporations suitably controlled, and to whom or what are they responsible? This is the central public issue, and the focal point for this paper.

One school of opinion holds that corporations cannot be adequately called to account because there are systematic economic and political failings. In this view, nothing short of a major overhaul will serve. What is envisioned, at least by many in this camp, are new kinds of corporate organizations constructed along the lines of democratic political institutions. The guiding ideology would be communitarian, with the needs and rights of the community emphasized in preference to profit-seeking goals now pursued by corporate leaders (presumably with Darwinian abandon, with natural selection weeding out the weak, and with society left to pick up the external costs).

Boards Changing For Better

Other critics take a more temperate view. They regard the present system as sound and its methods of governance as morally defensible. They concede, though, that changes are needed to reflect new conditions. Whether the changes are to be brought about by gentle persuasion, or require the use of a two-by-four to get the mule's attention, is part of the debate.

This paper sides with the gradualists. My position, based on a career in industry and personal observation of corporate boards at work, is that significant improvements have been made in recent years in corporate governance, and that more changes are coming in an orderly way; that with these amendments, corporations are accountable and better monitored than ever before; and that pat formulas or proposals for massive "restructuring" should be suspect. The formula approach often is based on ignorance of what it takes to run a large enterprise, on false premises as to the

corporate role in society, or on a philosophy that misreads the American tradition and leaves no room for large enterprises that are both free and efficient.

The draconian proposals would almost certainly yield the worst of all possibilities, a double-negative tradeoff: They would sacrifice the most valuable qualities of the enterprise system to gain the least attractive features of the governmental system. Privately owned enterprises are geared to a primary economic task, that of joining human talents and natural resources in the production and distribution of goods and services. That task is essential, and two centuries of national experience suggest these conclusions: The United States has been uncommonly successful at meeting economic needs through reliance on private initiative; and the competitive marketplace is a better course-correction device than governmental fiat. The enterprise system would have had to have failed miserably before the case could be made for replacing it with governmental dictum.

Big Business Is Target

Whether change is sought by stick or carrot, the subject of attention is invariably big business, the companies in the *Fortune* 500 or an even more select listing. Corporate governance is not an issue for corner drugstores (unless a conglomerate owns them) or the rest of the 99.9 percent of the two million incorporated businesses in the United States. Setting aside some procedural questions on the perimeter, the dispute about corporate governance drives straight to the issue of power and its control, and that question revolves today around large institutions almost to the exclusion of all others.

Take the question from the beginning: Why should the public have any interest in the internal affairs of corporations? Who cares who decides? Part of the answer comes from recent news stories noting such special problems as illegal corporate contributions to political campaigns, and tracking the decline and fall of once-stout companies such as Penn Central. Revelations of that kind raise questions about the probity and competence of the people minding the largest stores. There is more to it than this, though. There have always been cases of corporate failures. Small companies have gone under too, at a rate far higher than their larger brethren.[2] Instances of corruption have occurred in institutions of all sizes, whether they be commercial enterprises or some other kind.

Corporate behavior and performance are points of attention, and the issue attaches to size, precisely because people do not see the large private corporation as entirely private. People care about what goes on in the corporate interior because they see themselves as affected parties whether they work in such companies or not.

When companies are as large as Bank-America, Ford, and Du Pont, there is concern about the potential for anticompetitive behavior (which is to say, the power to do something that ultimately hurts consumers), and a more general, parallel concern about the way such organizations fit into a democratic society (which goes at the question of checks and balances).

Both sides of that coin need examination, and that calls for an excursion into history. It has long been an American premise that individuals have a right to launch enterprises if they choose to do so. There have been legal and ethical constraints, and some situations where the right of entry has deliberately been limited (as in controlled monopolies such as utilities), but mostly our society has let people decide for themselves whether to enter commerce and how to organize their ventures. Outsiders have expected no say in the internal deliberations on policy and structure.

The corporate form of organization came late to the scene. Large corporations as we know them today are mostly a 20th Century construction. The roots go back in time, though. The antecedent of the corporate charter was the charter originated by royalty to dispense privileges to favorites.

In the American experiment, it was decided corporations could be a useful option but that privilege and favoritism were traditions to do without. It was thus agreed that corporate charters should be made available to any and all citizens who wished to form such voluntary associations, and it was left to the states rather than the Federal Government to set up the ground rules.

The private character of corporate governance is now under challenge, on the grounds that corporate charters have been warped into instruments that license unchecked power. New constraints are demanded to protect the public interest and indeed, to protect the "volunteers" themselves, the corporate stockholders. This appeal is not merely for more regulation of the kind imposed in the past on product claims, competitive fair dealing and the like. It looks inward at policies and procedures, asking not "What is your company making and selling?" but "Who's calling the shots?" At issue here is the extent to which

voluntary associations shall remain private. Carried to an extreme, what may be foreseen is the dilution if not the elimination of the traditional property rights of the corporate owners.

There is no great mystery as to the source of this challenge. Three trends account for it. First is the growth of very large corporations. They have come to employ a large portion of the workforce, and have become key factors in the nation's technology, wealth and security. They have generated admiration for their prowess, but also fear of their imputed power.

The second contributing trend is the decline of owner-management. Over time, corporate shares have been dispersed. The owners have hired managers, entrusted them with the power to make decisions, and drifted away from involvement in corporate affairs except to meet statutory requirements (as, for example, to approve a stock split or elect a slate of directors).

Today only a handful of major U.S.-based corporations have top managements with significant or controlling ownership shares. Pollsters find few individual owners interested in participating in corporate decisions.[3] Mostly, they "vote with their feet" by buying or selling their shares. Much of the stock is held in pension and trust funds, investment groups, and university portfolios. Such institutional owners typically are interested in having corporations run well, not in running corporations themselves.

That raises obvious practical questions. If the owners are on the sidelines, what is to stop the managers from remaining in power indefinitely, using an inside position to control the selection of their own bosses, the directors? Who is looking over management's shoulder to monitor performance?

The third element here is the rise in social expectations regarding corporations. It is no longer considered enough for a company to make products and provide commercial services. The larger it is, the more it is expected to assume various obligations that once were met by individuals or communities, or were not met at all.

What Society Expects

Corporations are under pressure to create new jobs for young people coming into the labor force; to find work for the chronically unemployed and help train the unskilled; to maintain the economic security of older people no longer working; to take affirmative action to bring women and minorities up the ladder; to "give to the college of your choice" and otherwise help support education; to run fund drives for new hospitals and other-

wise help communities resolve local problems; and to extend "the business of the business" to cover major national needs, without being limited by the exigencies of one's chosen markets. The current example on this last point is the demand for big business to put its muscle to work to solve the energy problem. Pollution abatement was an earlier case.

Further pleas, now in the growth stage, are for the development of a more vigorous technology to reverse America's decline versus other industrialized nations, and at the same time, for the multinationals to share their technology *pro bono* with less developed countries, as a form of corporate foreign aid.

The debate about how far corporations can and ought to go down the social responsibility trail has been going on for decades.[4] In recent years, economist Milton Friedman has been popularly identified as the leading spokesman for the view that companies have already gone too far, too fast. His counsel is for companies to maximize their profits and leave the social work to others.[5] Another point of view, which I share, is that corporations have a duty to help make a better society as well as a better product, and that this is not a bad way to maximize profits long range.

From any vantage point, though, inside or outside the corporate world, there should be concern about corporations overreaching. It is not necessarily callous or antisocial to raise doubts about the competence of business managers to accept all the tasks pushed at them, and to ask what legitimates their appointment to social office. Sometimes, business seems to be drafted because it is presumed to have a deep pocket, and because society is looking for a place to dump problems. Because they have done well at economic missions, corporations may be presumed by some to be equally qualified for many other tasks, but that is a very risky assumption.

The point here is not to argue one position or another in the social responsibility debate, but only to suggest that with public expectations ratcheting upward, corporations are under pressure to behave more like governments and embrace a universe of problems. That would mean, of necessity, that private institutions would focus less on problems of their own choice.

If corporations succumbed to that pressure, and in effect declared the public's work to be their own, the next step would be to turn them into institutions accountable to the public in the same way that units of government are accountable.

Suppose that happened. What difference would it make? Apart from the philosophical difficulties (Can you have a free society if its economic engine is predominantly under governmental direction?), there are practical questions of efficiency.

There is also a fallacy in the notion that the democratic model could or should be applied to corporate governance. In the vernacular of economics, government manages assets owned by all of the citizens. Beyond the government's decisions, the people have no recourse. If they do not like the actions of government, their only logical course is to change what government does. They have no other place to turn. The political system, therefore, must be kept open to continuing debate and dissent, or freedom cannot be preserved. In that sense, the openness of government is its greatest strength; but it is also a weakness, for it results in an institution that moves hesitantly and ponderously. Government is pushed this way and that by rival forces, compromising the wishes of constituents, sometimes reversing its course line. It hears all voices, reasoned and unreasoned, arrives at no final decisions — even the Constitution gets amended — and sometimes (perhaps not often enough) decides to do nothing.

All of this is good for freedom — it gives totalitarianism no handle to seize — but as a means of getting work done it is notoriously inefficient. The public notices that shortcoming, grouses about it and pays for it, but finds it preferable to the alternative, a closed process in which protest could only take the route of the bumper sticker: America — Love It Or Leave It. Most people who love it intend not to leave it but to change it, and that is slow work.

No Parallel With Government

The corporation does not parallel the government. The assets in corporate hands are more limited and the constituents have options. There are levels of appeal. While the only accountability in government lies within government itself — the celebrated system of checks and balances among the executive, legislative, and judicial branches — the corporation is in a different situation: It has external and plural accountability, codified in the law and reinforced by social pressure. It must "answer" in one way or another to all levels of government, to competitors in the marketplace who would be happy to have the chance to increase their own market share, to employees who can strike or quit, and to consumers who can keep their wallets in their pockets. The

checks are formidable even if one excludes for purposes of argument the corporation's initial point of accountability, its stockholders (many of whom do in fact vote their shares, and do not just use their feet).

The case for major reforms in corporate governance rests heavily on the argument that past governmental regulation of large enterprises has been impotent or ineffectual. This is an altogether remarkable assertion, given the fact that the nation has come through a period in which large corporations have been subjected to an unprecedented flood of new legislation and rule making. Regulation now reaches into every corporate nook and cranny — including what some people suppose (erroneously) to be the sanctuary of the boardroom.

This leaves the proponents of more regulation with a predicament: If this vast package of regulations has failed so badly, why do they suppose that the answer lies in still more regulation? The answer surely is not self evident. If anything, the evidence seems to go the other way, to the conclusion that the panoply of regulation has spread so wide that it is smothering initiative and reducing personal as well as economic freedom. If there is political mileage in this today, it is not in advocating more regulation, but less.

It has been suggested that much of the past effort to regulate business has been neutralized because corporations have co-opted the overseers. An example often cited is the Interstate Commerce Commission, the charge being that the agency for years sheltered trucking companies and hurt the public by preventing new competitors from entering the business. It is one thing, though, to point to a few instances of this kind in the industry-centered agencies, and another to imply that all or most regulators are subverted or impotent. Big business swims today in alphabet soup — EPA, OSHA, FCC, FTC, SEC, FPC, ERISA, EEOC, and so forth — some being agencies organized around economic sectors but others cutting across the entire economy; and it is wrong, demonstrably wrong, to suggest that the people behind all those acronyms are in the corporate pocket, figuratively or literally.

There is no need here to detail government's prescriptions and proscriptions. Suffice it to say that at every turn, from the design of products to the disposal of wastes, from accounting practices to advertising claims, government today acts as a de facto partner in business decisions. It is an aggressive, sometimes effective, sometimes ineffectual, but rarely passive or silent partner.

Competition A Vigorous Force

Market competition, so lightly dismissed by some critics as fiction or artifact, is in fact a vigorous force in the affairs of almost all corporations. Size lends no immunity to its relentless pressures. The claim that the largest corporations somehow have set themselves above the play of market forces or, more likely make those forces play for themselves, is widely believed. Public opinion surveys show that. What is lacking is an evidence that this is so. Here too, the evidence goes the other way. Objective studies of concentrated industries (the auto industry, for instance) show that corporate size does not mean declining competitiveness, nor does it give assurance that the products will sell.

Everyday experience confirms this. Consider the hard times of the Chrysler Corporation today, the disappearance of many once-large companies from the American scene, and the constant roll-over in the membership list of the "100 Largest," a churning process that has been going on for years and shows no signs of abating.[6]

If indeed the two most prominent overseers of corporate behavior, government and competition, have failed to provide appropriate checks and balances, and if that is to be cited as evidence that corporations lack accountability, the burden of proof should rest with those who so state.

There is another pathway to follow. The issue is not always corporate performance, but sometimes is simply power. The objective of some corporate critics is not reform but control. They reason that if most stockholders are generally uninterested in close participation in corporate affairs, and the paid managers enjoy no great public support (at the moment their reputation is at a low in opinion polls), then this is the time to attack. Perhaps, the thinking goes, outsiders could seize the power to turn corporations to their own purposes. In that hope, some critics are trying to blaze a trail to the corporate boardroom.

There is nothing devious about this. Advocates of the most drastic changes in corporate governance often admit that this is their end, and celebrate it: They want to be able to decree specific actions — to force corporations to sell drugs under generic labels instead of trademarks, for instance, or to prevent the building of nuclear plants, or to stop companies from shutting down inefficient plants and laying off workers.

In sum, what these advocates want is for enterprise to favor

social "goods" (as they envision these) whenever there is a conflict with economic efficiency.

Whether the results they anticipate would turn into "goods" is another matter, and the degree of accountability of these advocates is also questionable.

The counterargument is that society's long-range interest is better served, on balance, by going just the other way — toward proprietary products which give producers the incentive to pay the high costs of doing research and development for new pharmaceuticals, toward nuclear power as an additional energy source that can be cleaner and safer than alternatives, and toward mobility in products and production units to retain a competitive position for American industry and to avoid the fossilization that has brought some other countries nearly to economic ruin.

The advocates in question are aware of such arguments but have made up their minds, and their concern now is with tactics. They see corporate governance as a means to an end.

One sign of this is the campaign for Federal chartering of large corporations. As an issue in itself, it is a red herring. The Federal Government already has the power it needs to monitor corporate behavior, through the disclosure premise of the securities laws. Corporations must disclose all material information to their owners and the public, and such disclosure is an effective, adequate instrument for regulation of corporations.[7]

Federal Chartering A Deceptive Issue

Federal chartering is a calculated, procedural move and its air of innocence is deceptive. If corporations were to be left to their voluntary status, and kept free to use their resources in any ways that are not illegal, then the chartering question would be much ado about nothing. What difference whether a piece of paper with a seal on it comes from Dover, Del., Harrisburg, Pa., or Washington, D.C.?

If the real intent, though, is to bring more of the corporate activity under political control, then Federal chartering could be a large step in that direction. It may be difficult to move the Federal Government to action, but it is far more frustrating to persuade 50 state governments to common action — especially when some of the 50 gain substantial revenues from the present corporate chartering process. Again, this message is not lost on the advocates of change. They acknowledge the essentially political goal.

The state of Delaware is trotted forward as the worst example of "the problem." This state is the seat of incorporation for 110,000 companies, including at least 40 percent of the companies listed on the New York Stock Exchange. It is inexpensive to incorporate in Delaware (one local resident makes money telling people how to start a Delaware corporation for less than $100), and the costs thereafter are low for nonresident firms. In the most recent fiscal year the state raised $60 million from corporate franchise taxes.[8]

One critic of the status quo, Professor William Cary of the Columbia Law School, regards Delaware as the leader in the race to "the bottom," that miserable title being earned by what he regards as the state's laxity in monitoring the companies to which it grants legal existence.[9]

Corporate decisions to incorporate in Delaware are often misunderstood. They make this choice not because Delaware's laws are loose and the authorities are looking the other way —for that is not the fact — but for reasons that anyone might applaud.[10] The Delaware Code is a modern, fair statute kept up to date by constant review. Corporations and members of the legal profession have developed confidence in the stability and wisdom demonstrated by the Delaware courts. This high reputation has been earned over the years by opinions written by judges who are extraordinarily knowledgeable, among them former Chancellor Collins J. Seitz, now Chief Judge of the Federal Court of Appeals for the Third Circuit.[11]

Delaware is simply one place that it makes good sense for a corporation to call home base, and many corporations would rather have their affairs in that jurisdiction than in any other. Nothing in the record suggests that stockholders and the public are therefore badly served. Delaware and other states do not, however, involve themselves in the selection of board members or stipulate their qualifications; and this, in the eyes of critics, may be the true failing of the states.

It is difficult in any event to sustain the general argument that corporations get away with anything because they hold state rather than Federal charters. Stockholders in a number of corporations have successfully sued errant managements for breaches of fiduciary duties, and those suits have come under state laws.[12]

To bring the corporate governance issue to a head, and identify the most sensible steps to take, some sequence of logic must be brought to the debate. Otherwise, we are likely to go on with

charges and countercharges, and an overabundance of fiery speeches impugning motives, but failing to deal with proposals on their merits.

There is a middle ground. Political power plays aside, even the more opinionated debaters may not be as far apart as they suppose. In that conviction, a reasonable way to attack the issue of governance is to start with the premise that all proposals are grounded in noble intentions, and to look at basic goals before worrying about structure.

The first step in such an analysis is to define the limits as well as the responsibilities the large corporation is to meet in society. Then a statement is needed of the requirements to be met if the corporation is to deliver on the contract. After that come the questions about the construction of boards, the prerequisites for membership, and any action that ought or ought not be taken to assure the future accountability of the corporation.

There is little point in theorizing about the corporate role. The practical fact is that the public has drawn up its list of expectations, and it wants results. What people want, in part and at minimum, is for big corporations to meet the same test that applies to business units of smaller size: that is, to provide products and services of advertised quality and utility, and to do so competently, responsibly, and ethically.

Extra Expected of Larger Firms

The basics apply to Sears Roebuck as much as to Sam's appliance shop. Wherever you buy the new toaster, it should work when it is plugged in. Whoever services the washing machine, the repairman should arrive at the appointed time, with tools and parts.

Special expectations are added for the largest firms, however. One is that they apply their resources to tasks that invite economies of scale, providing goods and services that would not otherwise be available, or that could be delivered by smaller units only at considerable loss of efficiency. Another is that, like the elephant, they watch where they put their feet and not stamp on smaller creatures through clumsiness or otherwise.

A second set of requirements can be added, related not to the markets selected by corporations individually, but to the larger economic tasks that must be accomplished in the name of the national interest and security. In concert with others in society, including big government, big corporations are expected to hus-

band scarce resources and develop new ones, and to foster strong and diverse programs of research and development, to the end that practical technological improvements will emerge and the nation will be competitive in the international setting.

Beyond this there are softer but nonetheless important obligations: To operate with respect for the environment and with careful attention to the health and safety of people; to honor and give room to the personal qualities employees bring to their jobs, including their need to make an identifiable mark and to realize as much of their potential as possible; to lend assistance in filling community needs in which corporations have some stake; and to help offset community problems which in some measure corporations have helped to create.

This is not an impossible job, only a difficult one. Admitting that the assignment probably is not going to be carried out perfectly by any organization, the task is unlikely to be done even half well unless some boundary conditions are met. Large corporations cannot fulfill their duties unless they remain both profitable and flexible. They must be able to attract and hold those volunteer owners; which is to say, there must be the promise of present or future gain. Companies must have the wherewithal to reinvest significant amounts to revitalize their own capital plants, year after year in unending fashion. Otherwise, it is inevitable that they will go into decline versus competitors elsewhere, as will the nation.

Flexibility is no less important. The fields of endeavor engaging large business units today are dynamic in nature. Without an in-and-out flow of products and services, without the mobility to adapt to shifts in opportunities and public preferences, corporations would face the fate of the buggy-whip makers.

Profitability and flexibility are easy words to say, but in practice they make for hard decisions. A company that would close a plant with no more than a passing thought for those left unemployed would and should be charged with irresponsibility; but a firm that vowed never to close any of its plants would be equally irresponsible, for it might be consigning itself to a pattern of stagnation that could ultimately cost the jobs of people in all of its plants.

The central requirement is not that large corporations take the pledge and bind themselves to stated actions covering all circumstances, but that they do a thoughtful and informed job of balancing competing (and ever changing) claims on corporate

resources, mediating among the conflicting (also changing) desires of various constituencies, and not giving in to any one-dimensional perspective however sincerely felt. It is this that describes responsible corporate governance.

Corporations Have Limits

Corporate directors and managers cannot set and carry out policies in a vacuum, for other groups in society see themselves as stakeholders with claims to assert. Nor is it probable that the final decisions will please everybody. It is a near certainty that they will not, because conflicting claims can only be resolved with trade-offs. A larger piece of the pie for employees means a smaller piece for the owners, or vice versa; and if the claims of both groups were met in full, there might be nothing left over for reinvestment for the future good of either group.

It is also important to be realistic about the limits of the corporation. Large companies are not good at some jobs and are distinctly second best at others. In the matter of job creation, for example, it is the new and smaller firms that today add most to the growth in employment opportunities in the United States; employment in the largest industrial firms has grown little in recent years, those firms tending to be high-technology, capital-intensive operations, while smaller companies and the service industries harbor most of the labor-intensive operations.

Where large corporations probably can make their best contribution in employment is in the creation of new products and technologies that, in turn, expand customer companies and industries. For example, while employment in the large chemical companies in the United States may be growing slowly if at all, jobs have expanded rapidly over the years in companies that buy plastics, inorganics, and other chemical products, and turn these into consumer goods.

The logic of limits has to apply to the social as well as to the economic sector. Large corporations are good at creating new national wealth and income; they were not designed to redistribute it or to correct the shortcomings and inequities of community life. It is not suggested that corporate leaders turn their backs on societal problems, only that they and others recognize that corporations cannot be all things to all men, that a career in a large corporation does not equip an individual to solve any and all problems, and that it is usually a mistake to ask corporations to do what governments should do but may have failed to do.

Certainly, corporations do not have the public mandate or the resources to be what Professor George Lodge of the Harvard Business School would have them be, which is nationally chartered community-oriented collectives.[13] Such a mission for corporations would be tolerable to society only if corporations were turned into mini-governments — but that takes us back to the inefficiency problem noted earlier. The one task governments have proven they almost always do badly is to run production and distribution organizations. The only models there are to follow are not attractive. Would anyone seriously argue that the public would be ahead if General Motors were run along the lines of Amtrak, or Du Pont were managed in the manner of the U.S. Postal System?

Once roles are defined, the key to success in running a large corporation is to lay out a suitable division of labor between the board and the management, make that division crystal clear on both sides, and staff the offices with the right people. Perhaps the best way to make that split is to follow the pattern used in the U.S. Constitution, which stipulates the powers of the Federal Government and specifies that everything not covered there is reserved to the states or the people thereof. The board of directors should lay claim to five basic jobs, and leave the rest to the paid managers.

The duties the board should not delegate are these:

1. The determination of the broad policies and the general direction the efforts of the enterprise should take.
2. The establishment of performance standards — ethical as well as commercial — against which the management will be judged, and the communication of these standards to the management in unambiguous terms.
3. The selection of company officers, and attention to the question of succession.
4. The review of top management's performance in following the overall strategy and meeting the board's standards as well as legal requirements.
5. The communication of the organization's goals and standards to those who have a significant stake in its activities (insiders and outsiders both) and of the steps being taken to keep the organization responsive to the needs of those people.

The establishment of corporate strategy and performance standards denotes a philosophy of active stewardship, rather than passive trusteeship. It is the mission of directors to see that corporate resources are put to creative use, and in the bargain subjected to calculated risks rather than simply being tucked into the countinghouse for safekeeping.

That in turn implies certain prerequisites for board members of large corporations which go beyond those required of a school board member, a trustee of a charitable organization, or a director of a small, local business firm. In any such assignments one would look for personal integrity, interest and intelligence, but beyond these there is a dividing line that marks capability and training.

The stakes are likely to be high in the large corporation, and the factors confronting the board and management usually are complex. The elements weighing heavily in decisions are not those with which people become familiar in the ordinary course of day-to-day life, as might be the case with a school board.

Judgment Is Crucial

Corporate board members need special perspective and experience to handle multivariable problems, many of which, at the time decisions must be made, have open-ended connotations. The board and management know there are risks. They may even be able to quantify these; but they do not therefore "know" the correct course to take. Judgment thus becomes crucial.

Typically, there is no one strategy that is unassailably right for a corporation even by hindsight; there are only some alternative courses, several of which might work out well. The only thing known is that, whatever course is taken, once the people and dollars are committed there is no turning back the clock.

The dimensions of decisions in large corporations can be suggested with a few examples. General Motors decided several years ago to build its future around smaller cars. Experience now says that was a wise move, but at the time the choice was made, some other large and successful auto makers were deciding not to make that move. G.M. made its commitment to a new product mix with billions of dollars on the line.

IBM faced a decision of similar magnitude when it decided some years ago to bet its future on the new world of electronics and computers, and move away from punch cards and manual sorters. Citicorp overhauled its strategy from that of running a banking operation in the narrow sense, to operating a full-range

financial service organization in all parts of the world. Du Pont made a succession of decisions in its diversification history, as it progressed from an explosives manufacturer to a company producing man-made fibers, plastics, biochemicals, and other product lines each of which, today, is a bigger business than the company's initial line.

On the other side of the coin, corporations must decide when to abandon lines of effort as well as start new ones. It happens sooner or later in every dynamic company. Du Pont recently announced that it is leaving the dyes business, after 60 years in the field. The company also has faced the trauma of abandoning production of the product the company was founded in 1802 to make, black powder.

Whether products and services are going or coming, it is increasingly the case that decisions about them have international loadings. Most of the companies in the spotlight on corporate governance have substantial operations outside the U.S., on their own or in partnership with other companies. This simply ups the ante, adds to the complexities, and increases uncertainties (the corporate leaders are now trying to cope with differences in economic outlook, governmental policies, and culture in many nations).

Internationalism also complicates the search for directors. As one corporate chairman has put it, ". . . we need people who understand the various ballgames from Mexico to Morocco to Canada to Italy to Germany."[14] That could apply to many companies in a world of increasingly multinational commerce. It covers conjunctions of many kinds, for the ways of finance, technological change, and of employee and stockholder relations vary from country to country.

Whatever the span of product interests, large companies often find international problems thrust upon them. The chemical industry, to take that example again, builds most of its products from petroleum stocks. Those are its raw materials in the same way that ore is a raw material for steelmakers. Whatever affects the price or availability of oil and natural gas affects the large chemical companies, and their boards cannot pass judgment on plans for the future without giving heavy allowance to this.

Ordinarily the management of a corporation attends to such matters as product introductions, capital expansions, and supply problems. This in no way reduces the need for directors with extensive business background. With few exceptions, corporate

boards involve themselves in strategic decisions and those involving large capital commitments. Directors thus need at least as much breadth and perspective as the management, if not as much detailed knowledge.

If the directors are to help provide informed and principled oversight of corporate affairs, a good number of them must provide windows to the outside world. That is at least part of the rationale for outside directors, and especially for directors who can bring unique perspective to the group. There is an equally strong case, though, for directors with an intimate knowledge of the company's business, and insiders may be the best qualified to deliver that. What is important is not that a ratio be established, but that the group contain a full range of the competences needed to set courses of action that will largely determine the long-range success of the enterprise.

Boards Need Windows

The directors also have to be able and willing to invest considerable time in their work. In this day and age, with major resources on the line and tens of thousands of employees affected by each large corporation, there should be no seat in the boardroom for people willing only to show up once a month to pour holy water over decisions already made. Corporate boards need windows, not window dressing!

There are two other qualities that may be self-evident from what has been said, but are mentioned for emphasis. Directors must be interested in the job and committed to the overall purpose of the organization. However much they may differ on details of accomplishment, they must be willing to work at the task of working with others on the board. They ought to be able to speak freely in a climate that encourages open discussion, but to recognize the difference between attacking an idea and attacking the person who presents it. No less must they see the difference between compromising tactics to reach consensus and compromising principles.

Structures and procedures, which so often are pushed to the fore in discussions of corporate governance, actually belong last. They are not unimportant, but they are subordinate.

Structure follows purpose, or should, and that is a useful principle for testing some of the proposals for future changes in corporate boards. Today, two-thirds to three-quarters of the directors of most large corporations are outsiders, and it is being proposed

that this trend be pushed still farther, with the only insider being the chief executive officer, and with a further stipulation that he not be board chairman. This idea has surfaced from Harold Williams,[15] and variations on it have come from other sources.

The idea bumps into immediate difficulties. High-quality candidates for boards are not in large supply as it is. Conflicts of interest would prohibit selection of many individuals close enough to an industry to be familiar with its problems. The disqualification of insiders would reduce the selection pool to a still smaller number, and the net result could well be corporate boards whose members were less competent and effective than those now sitting.

Experience would also suggest that such a board would be the most easily manipulated of all. That should be no trick at all for a skillful CEO, for he would be the only person in the room with a close, personal knowledge of the business.

The objective is unassailable: Corporate boards need directors with independence of judgment; but in today's business world, independence is not enough. In coping with such problems as those confronting the electronics corporations beset by heavy foreign competition, or those encountered by international banks which have loans outstanding in countries with shaky governments, boards made up almost entirely of outsiders would not just have trouble evaluating nuances of the management's performance; they might not even be able to read the radar and tell whether the helmsman was steering straight for the rocks.

If inadequately prepared individuals are placed on corporate boards, no amount of sincerity on their part can offset the shortcoming. The jury system offers an analogy. For some legal cases a jury of citizens picked from public rosters is the best of alternatives. The prosecution and defense could not be in better hands. In more complex and prolonged cases, though, a panel of average citizens may be almost helpless, and no one's interest is served by asking them to devote a major chunk of their time to arrive at decisions in which they themselves have no confidence.

If a case involves antitrust or scientific and engineering matters, a jury of laymen may find arguments on all sides incomprehensible. If it is a major civil action of any kind, it may take months to try. Often, days are required just for the trial judge to instruct the jury on the legal issues, after which the jury is left to ponder exhibits and transcripts that fill not only file folders, but file cabinets.

Chief Justice Warren Burger has called attention to this problem and has challenged the legal profession to face up to it. He suggests trying such cases without a jury (as has been done for almost 200 years in Admiralty cases, and as the English do in almost all their civil cases). An alternative would be trials by special juries with appropriate credentials in the areas at issue.[16]

Turning the point back to the corporate governance issue, it is pure illusion to suppose that complex business issues and organizational problems can be overseen by people with little or no experience in dealing with such problems. However intelligent such people might be, the effect of their governance would be to expose the people most affected by the organization — employees, owners, customers, suppliers — to leadership that would be (using the word precisely) incompetent.

Even the best-qualified directors need to be kept up to date on the state of the business. To that end, one suggestion is that outside directors be provided their own staffs, independent of the management's control.

There is no quarrel with the need for information, but this proposal all but guarantees an adversarial climate in an area where contention is less productive than collaboration.

People joined in a corporate effort presumably are all on the same side, and directors ought to be able to obtain what they need to know by calling on the same company specialists serving the managers, and indeed on the same data and reports. Rather than set up redundant staffs, board members should insist on communications systems to feed them agreed-upon kinds of information, in advance of board meetings and with sufficient lead time to examine open questions. Some boards have such communications systems in place; many do not. This is a prime area for improvement, which corporations are free to pursue under the doctrine of "Physician, heal thyself."

Incompatible Goals

It is sometimes suggested that the members of corporate boards ought to come from the constituencies — an employee-director, a consumer-director, an environmentalist-director, etc. This Noah's Ark proposal, which is probably not to be taken seriously, is an extension of the false parallel between corporations and elected governments. The flaw in the idea is all but self-evident: People representing specific interest groups would be definition be committed to the goals of their groups rather than

any others; but it is the responsibility of directors (not simply by tradition but as a matter of law as well) to serve the organization as a whole. The two goals are incompatible.

If there were such boards they would move at glacial speed. The internal political maneuvering would be Byzantine, and it is difficult to see how the directors could avoid an obvious challenge of accountability. Stockholder suits would pop up like dandelions in the spring.

One may also question how many people of ability would stand for election under this arrangement. Quotas are an anathema in a free society, and their indulgence here would insult the constituencies themselves — a woman on the board not because she is competent but only because she is female; a black for black's sake; and so on ad nauseam.

A certain amount of constituency pleading is not all bad, as long as it is part of a corporate commitment. There is something to be said for what Harold Williams labels "tension," referring to the divergence in perspective of those concerned primarily with internal matters and those looking more at the broader questions.[17] However, as has been suggested by James Shepley, the president of Time, Inc., "tension" can lead to paralysis, and is likely to do so if boards are packed with groups known to be unsympathetic to the management's problems and business realities.

As Shepley commented, "The chief executive would be out of his mind who would take a risk-laden business proposition to a group of directors who, whatever their other merits, do not really understand the fine points of the business at hand, and whose official purpose is to create 'tension.'"[18]

Students of corporate affairs have an abundance of suggestions for organizing the work of boards, with detailed structures in mind for committees on audit, finance, and other areas; plus prescriptions for membership. The danger here is not that boards will pick the wrong formula — many organization charts could be made to work — but that boards will put too much emphasis on the wrong details.

The idea of utilizing a committee system in which sub-groups have designated duties, is far more important than the particulars of their arrangement. When such committees exist, and they are given known and specific oversight duties, it is a signal to the outside world (and to the management) that performance is being monitored in a no-nonsense fashion.

It is this argument that has produced the rule change covering companies listed on the New York Stock Exchange, calling for audit committees chaired by outside directors, and including no one currently active in management. Most large firms have moved in that direction, and the move makes sense, for an independently minded audit committee is a potent instrument of corporate oversight. Even a rule of that kind, though, has the potential of backfiring.

Suppose some of the directors best qualified to perform the audit function are not outsiders? Are the analytical skills and knowledge of career employees therefore to be bypassed? Are the corporate constituencies well served by such an exclusionary rule, keeping in mind that all directors, insiders or outsiders, are bound by the same legal codes and corporate books are still subject to independent, outside audit? It is scarcely a case of the corporate purse being placed in the hands of the unwatched.

Repeatedly, the question of structure turns on the basics: If corporations have people with competence and commitment on their boards, structure and process fall into line easily; if people with the needed qualities are missing or the performance standards are unclear, corporations are in trouble no matter whose guidebook they follow. Equally, the question drives to alternatives: The present system is surely not perfect, but what is better?

Old Fundamentals Still Sound

By the analysis presented here the old fundamentals are still sound, no alternative for radical change has been defended with successful argument, and the best course appears to be to stay within the historical and philosophical traditions of American enterprise, working out the remaining problems one by one.

That is the route being followed, and it seems to be working. In recent years, pressed by law or public criticism, and stung by glaring errors committed by specific large companies, the directors of many companies have done a good bit of soul-searching. They have regrouped and reorganized. Key private institutions have examined the issues and made useful suggestions. For example, both the American Bar Association and the Business Roundtable, an organization of about 190 chief executive officers, have issued detailed statements on corporate conduct and the role of directors. As a result of these individual and collective efforts, corporate boards are now more strongly manned, more sensitive to the world around them, and more open to view than they have ever been before.[19]

This is all to the good, but some further change is desirable and necessary. At least two areas invite special attention: Corporate ethics and corporate disclosure. They are of course related.

Given the past instances of corporate wrongdoing and the public conviction that such behavior is not only commonplace but condoned, corporate leaders have no choice but to state the standards by which they intend to play the game. A code of conduct needs to come from the board; it needs to be put in plain language; and it needs to be made public.

Universal Code Impractical

Having wrestled with codes of conduct for the past five years or so, corporate leaders seem to agree that no one piece of paper will fit universally, except one so couched in generalities as to be useless — that is to say, one that permits no tests for compliance and thus is incapable of enforcement. The conclusion is that each company must prepare its own list of do's and don't's, citing specifics on the behavior that is out of bounds, and noting the punishment for stepping out of the line.

Not every question of business ethics can be reduced to black and white, but in thinking about this there is again a useful analogy in the law.

The Sherman Act, which is the cornerstone of U.S. antitrust law, makes a distinction between per se offenses and other actions which are deemed right or wrong in the light of circumstances. A similar distinction can be made in a corporate code of conduct.

Some kinds of conduct are never to be condoned. An example would be the bribery of government officials, for whether this is done at home or abroad it subverts the governmental process and arrogates to the corporation a power the public rightly does not wish it to have. By the same token, a corporation could not justify selling in one country a product that has been tested and ruled inherently unsafe by authorities in other countries. Such a ban would apply whether or not the nation importing the product knew of the hazards.

In the gray area are such questions as corporate political contributions. This is the sort of question each corporation ought to decide for itself, for such gifts are permissable in some nations though explicitly prohibited for Federal elections in the United States. U.S. mores in this respect are not necessarily morally superior to those of other nations, some of which find no meaning-

ful distinction between individual and corporate participation in political funding.

The best practical test of a corporate code, and of conduct under it, is not how closely it matches rules that might be etched in bronze by one authority or another, but how well it permits people in corporate positions to answer an everyday question:

Would they be comfortable with a public disclosure of the behavior that is countenanced by the code, given a full chance to explain the circumstances?

Corporations could serve their own cause by liberalizing their disclosure policies. For years most companies have played their cards too close to the vest. They have held back more facts about their businesses than necessary to protect their competitive positions, and have declined to explain to interested outsiders (or even their own employees) what standards the management embraced, what directions it saw for the future, and what might be expected if the company experienced market setbacks or other problems.

In retrospect, too many corporations have disclosed too little to retain public confidence in either the integrity or performance of their leaders. For the large companies this has been costly, for big business has never been free from latent distrust in this country, and the relative silence and anonymity of corporate leadership has contributed to a steady deterioration of the political and social environment.

It is too much to say that this decline could have been prevented by a more open disclosure policy, both as to business data and management commitments, or by a greater visibility on the part of business leaders. The public reputation of all prominent institutions in American life has skidded in recent years.

What can be claimed is that big business has made its own problems worse, that its falling reputation has hurt society as well as specific corporations, and that a turnaround is needed for the future.

Professor Christopher Stone of the University of Southern California has illuminated this point:

> What is most evidently missing today and needs to be restored is a measure of mutual trust and respect. As things stand, we are settling into a cycle in which the laws wielded against corporations are products of little more than mutual frustration, a cycle which is giving the businessman fits, and the public little to show for it . . . (S)ociety, distrustful of

what is going on within the corporation's walls, and kept at arm's length from the loci of corporate decision making, sees little choice but to slap together a battery of new regulations even before it is adequately informed. There are obvious costs to both sides.[20]

Corporate boards are the first place to look for policies that can help restore trust and respect. The windows they have constructed to look out can also be used to let people look in. The thought that outsiders will see commercial secrets and pass them on to competitors is not an excuse for drawing the curtain. Proprietary knowledge is extremely valuable to corporations — directors and managers would be delinquent if they failed to protect it — but the kinds of commercial information that have such value are fairly easily identified and kept from accidental exposure.

Often, those kinds of facts are not the ones in question. What people want to know is not what the company is doing commercially, but simply what kind of people are running the show. In effect they are asking, "Who are you and what do you believe in?" Neither question is hard to answer and, in view of the leverage that large corporations have on people's lives today, it is difficult to see why anyone in a position of corporate governance would decline to answer.

More Open Policies Needed

For a long time, the operating principle on disclosure followed by most corporations was to let out what was required by law, and keep back everything else unless someone could show cause why it should be released. The familiar test question, well known to all who have served their time in the corporate interior, was, "Have we ever said that before?" Today, the more appropriate disclosure principle would be the reverse: Whoever wants to hold back relevant material information should show cause why it should not be revealed.

More open policies of that kind, strengthened by formal and continuing communications programs, could have an impressive impact on public opinion, and would demonstrate better than a thousand lectures that corporations are being governed properly.

The large corporation has long since earned its marks as an effective instrument for production and distribution. The task now is not to bring drastic change to the corporate interior,

turning business units into instruments of the national government, but to make those shifts that will best demonstrate that the large corporation is in the hands of people who are not only competent but also cognizant of the world around them, and properly accountable.

Footnotes

1. U.S. Senate, Committee on the Judiciary Subcommittee on Antitrust, Monopoly & Business Rights; Address by Harold M. Williams, *Corporate Accountability*, Fifth Annual Securities Regulation Institute, San Diego, California (January 18, 1978); W. Cary, *A Proposed Federal Corporate Minimum Standards Act*, 29 Bus. Law. 1101 (1974) and W. Cary, *Federalism & Corporate Law: Reflections Upon Delaware*, 83 Yale L.J., 663 (1974); D.E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 Bus. Law. 1125 (1976); M.A. Eisenberg, *Legal Modes of Management Structure in the Modern Corporation; Officers, Directors & Accountants*, 63 Calif. L. Rev. 375 (1975); A.J. Goldberg, *Debate on Outside Directors, New York Times*, October 29, 1979 (§3, p. 1); Ralph Nader & Mark Green, *Constitutionalizing the Corporation: The Case for Federal Chartering of Giant Corporations* (1976).

2. See *Sixty Years of Corporate Ups, Downs & Outs, Forbes*, September 15, 1977, p. 127 *et seq.* and the statement by Dr. Betty Bock of the Conference Board at the hearing of the Senate Subcommittee on Anti-trust considering S.600, Small & Independent Business Protection Act of 1979, April 25, 1979. In regard to small business see *The Securities and Exchange Commission's Response to the Problems of Small Business*, an address by Harold M. Williams, White House Conference on Small Business, New York, New York, April 5, 1979.

3. *1978 Shareowner Attitude Survey*, Opinion Research Corporation conducted for the Business Roundtable, 26 (1978).

4. An indication of the length of time that the debate has continued and how the tenor of the debate has changed can be seen in a Note entitled "Restriction of Activities of Business Corporations to Profit Making" in E. Dodd & R. Baker, *Cases & Materials on Corporations* 330-33 (2d ed. 1951). The Note quotes Lord

Justice Bowen's famous statement in *Hutton v. West Cork Ry. Co.*, 23 Ch.D. 657, 673 (Ct. App. 1883) where the "cakes & ale for the benefit of the corporation" test is set forth: "The law does not say that there are to be no cakes and ale [as gratuities for employees], but there are to be no cakes and ale except such as are required for the benefit of the company . . . [T]hat sort of liberal dealing with servants eases the friction between masters and servants, and is, in the end, a benefit to the company. It is not charity sitting at the board of directors, because as it seems to me charity has no business to sit at boards of directors qua charity. There is, however, a kind of charitable dealing which is for the interest of those who practice it, and to that extent and in that garb (I admit not a very philanthropic garb) charity may sit at the board, but for no other purpose."

Dodd and Baker wrote in this 1951 Note: "The view that the management of a business corporation owes at least moral obligations to persons other than shareholders, in particular to employees and consumers but to some extent to the community as a whole, is frequently expressed today, sometimes by corporate managers themselves, but attempts to reconcile that view with the orthodox legal theory that the purpose of the business corporation is the private profit of the shareholders and that the managers are elected to accomplish that purpose have rarely been made. For discussions of the subject see Dodd, *For Whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145 (1932), but cf. Dodd, *Review of Dimock & Hyde, Bureaucracy and Trusteeship in Large Corporations*, 9 U. of Chi. L. Rev. 538, 546 (1942); Berle, *For Whom Corporate Managers Are Trustees*, a Note, 45 Harv. L. Rev. 1365 (1932); Berle and Warren, *Cases and Materials on the Law of Business Organization*, 1102 (1948)."

5. M. Friedman, *The Social Responsibility of Business is to Increase its Profits*, *N.Y. Times*, September 13, 1970, (Magazine); J.K. Galbraith, *The New Industrial State* (1967).

6. *See* Dr. Betty Bock's Statement before Hearings on S.600, Small and Independent Business Protection Act of 1979, April 25, 1979 and the article *Sixty Years of Corporate Ups, Downs & Outs* in *Forbes*, September 17, 1977 at p. 127 *et seq.*

7. *See* W. Cary, *Corporate Standards and Legal Rules*, 50 Calif. L. Rev. 408, 411 (1962) where he states: ". . . disclosure restrains because of the sensitivity of public reaction, caution about response to the 'dissident shareholder' and the possibility of legal

action. I firmly believe that disclosure does operate in this deterrent manner." The deterrent effect as an aspect of the disclosure required by the securities laws in addition to providing an intelligent basis for investor decisions has been recognized as an important element of investor protection. *See* W.E. Van Valkenberg, *Corporate Disclosure Under the Securities Act of 1933 and the Securities Exchange Act of 1934: A Historical Perspective* at p. 564-65, *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission*, November 3, 1977.

With respect to disclosure in solicitations of the stockholders, the United States Supreme Court has stated:

> . . . the purpose of Section 14(a) of the Exchange Act is to prevent management or others from obtaining authorization for corporate actions by means of deceptive or inadequate disclosure in proxy solicitations. The section stemmed from the Congressional belief that "fair" corporate suffrage is an important right that should attach to every equity security bought on a public exchange. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964).

8. *See* P. Dodd & R. Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation*, Managerial Economics Research Center, University of Rochester, 4 (1978).

9. W. Cary, *Federalism & Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 at 705 (1974).

10. For interesting results of a study on competition among states for corporate charters see P. Dodd & R. Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation*; Managerial Economics Research Center, University of Rochester (1978); *Review & Outlook, Facts on Federal Chartering, Wall St. J.*, November 28, 1978.

11. Chief Judge Collins J. Seitz was a vice chancellor of the Delaware Court of Chancery from 1946 to 1951 and chancellor from 1951 until 1966 when he was appointed to the U.S. Court of Appeals for the 3rd Circuit. In 1971 he became chief judge of that court.

12. These cases have established a tough line of accountability and duty to shareholders and consequently the public. *See Jones v. Ahmanson & Company*, 81 Cal. Rptr. 592, 460 P.2d 464 (1969);

Singer v. Magnavox, 380 A.2d 969 (Del. 1977); *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. 1949); *Guth v. Loft*, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 301 N.Y.S. 2d 78, 248 N.E.2d 910 (1969).

13. G. Lodge, *The New American Ideology* (1975).

14. Remarks of Henry P. Becton, Chairman of Becton, Dickinson & Co., at meeting of National Association of Corporate Directors reported in S.H. Scheible, *Heat on Directors, A Revolution is Occurring in the Boardroom, Barron's* July 30, 1979, 4 at 27.

15. Address by Harold M. Williams, *Corporate Accountability*, Fifth Annual Securities Regulation Institute, San Diego, California, January 18, 1978.

16. Address by Chief Justice Warren E. Burger, *Use of Lay Jurors in Complicated Civil Cases*, Conference of State Chief Justices, Flagstaff, Arizona, August 7, 1979. After urging that the state judiciary and state bar associations join in a study on the selective use of lay jurors in certain civil cases — i.e., protracted and complicated civil litigation requiring more than one month to try, the Chief Justice concluded with the following recommendation:

> Meanwhile, without waiting for the kind of study called for — a study that will take time — some innovative lawyers should, as indeed some have done, waive juries in the complicated trials of a month or more. For those who might be inhibited or uneasy about the "luck of the draw" on whether the assigned judge is sophisticated in complex economic, business or environmental cases, I know of no barrier to stipulating that the case be tried initially by not one, but three judges.

For a discussion of the constitutional issues involved in dispensing with a jury in such cases, *see* Note, *The Right to a Jury Trial in Complex Civil Litigation*, 92 Harv. L. Rev. 898 (1979). From a different perspective, *see* I.S. Shapiro *Managing the Judicial System: A Businessman's View*, 64 ABA J. 1672, 1674 (November, 1978).

17. Address by Harold M. Williams, *Corporate Accountability*, Fifth Annual Securities Regulation Institute, San Diego, California, January 18, 1978 and further explored in the address before the Economic Club of Detroit, May 1, 1978, *The Role of the Director in Corporate Accountability*.

18. J. Shepley, *The CEO Goes to Washington*, Remarks to Fortune Corporation Communications Seminar, March 28, 1979.

19. The Section of Banking, Corporation & Business Law of the American Bar Association approved the *Corporate Directors Guidebook*, 33 Bus. Law. 1591 (1978), which provides a general overview of the functions and responsibilities of the corporate director in order to assist the corporate director in performing his duties. This has recently been supplemented by a report on *The Overview Committees of the Board of Directors*, 34 Bus. Law. 1837 (1979), prepared by the Committee on Corporate Laws which is being reviewed by the Council of the Section of Banking, Corporation & Business Law. The purpose of this report is to examine the responsibilities appropriate for assignment to each of three recommended working committees of the board of directors among other considerations.

The Business Roundtable issued a statement on *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporations*, 33 Bus. Law. 2083 (1978) which had as its stated purpose to analyze the proper role of a board of directors in the conduct of corporate affairs from the perspective of managers responsible for the effective performance of the economic functions of an enterprise and for meeting other responsibilities.

Numerous studies and surveys have been made in recent years showing the changes that have occurred and making the board of directors more sensitive and responsive to the world. *See Corporate Governance/Survey of Corporate Boards, Structure & Composition*, New York Stock Exchange and American Society of Corporate Secretaries, January, 1979.

20. C. Stone, *Where the Law Ends, the Social Control of Corporate Behavior* (1975).